STAFF PAPER

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IASB Meeting

Project	**Rate-regulated Activities**		
Paper topic	Presentation and disclosure objective—education session		
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Purpose of this paper

1. The purpose of this paper is to seek comments from Board members about:
    (a) the staff's initial views on a high-level presentation and disclosure objective for the model we are developing for defined rate regulation (the model) (paragraphs 4-22);
    (b) exploring presentation formats for the statement(s) of financial performance (paragraphs 23-31); and
    (c) the staff's initial views on a couple of gross versus net presentation issues arising from interactions with other IFRS Standards (paragraphs 32-46).
2. We will consider the comments when subsequently developing presentation and disclosure requirements for the model.

Staff's initial views on a high-level presentation and disclosure objective

3. An initial high-level presentation and disclosure objective for the model could be as follows:

> An entity shall present and disclose information that enables users of financial statements to assess and distinguish between:
>
> - fluctuations in revenue and expenses compensated for through the rate-adjustment mechanism; and
> - fluctuations in revenue and expenses for which there is no compensation.
>
> This information will be useful because it will allow users to assess the amounts, timing and uncertainty of future cash flows arising from regulatory assets and regulatory liabilities.

4. To build this initial high-level presentation and disclosure objective we have considered:

   (a) the Board's discussions in the Disclosure Initiative—Targeted Standards-level Review of Disclosures project on how the Board will use disclosure objectives when developing disclosure requirements in the future (paragraphs 5-7);

   (b) the objective of the model and information needs of users of financial statements (paragraphs 8-12);

   (c) the disclosure objective in IFRS 14 *Regulatory Deferral Accounts* and initial feedback received on it (paragraphs 13-14); and

   (d) previous Board discussions about presentation within the model (paragraphs 15-17).

Disclosure Initiative

5. At its May 2018 meeting,[1] the Board discussed the development of guidance for use when developing and drafting disclosure requirements and, in particular, how the Board will use disclosure objectives going forward.

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[1] See Agenda Paper 11B discussed at the May 2018 Board meeting. The agenda paper can be found at: https://www.ifrs.org/-/media/feature/meetings/2018/may/iasb/ap11b-di.pdf

6. The Board tentatively decided that when developing and drafting disclosure requirements in future, it will:

   (a) base all disclosure requirements on one or more specific disclosure objectives. These objectives should explain why the information is useful to the primary users of financial statements, and what primary users of financial statements are expected to do with the information.

   (b) draft all disclosure requirements so they explicitly state the underlying objective(s) and clearly link each item of information included in disclosure requirements with the related objective(s).

7. The Board also tentatively decided that it will continue to use high-level disclosure objectives within individual IFRS Standards. The purpose of these objectives would be to prompt entities to consider the overall disclosure relating to a particular topic in their financial statements and whether the information provided meets user information needs for that topic.

Objective of the model and user needs

8. The objective of the model is to account for an entity's incremental rights and obligations arising from timing differences that are created when an entity fulfils service requirements in a different period than the period in which those service requirements are charged to customers through the regulated rate. Those timing differences result in fluctuations in revenue and related expenses because the effects of some transactions or other events are reported as income or expenses in a different period than the period in which the transaction or event takes place (see Agenda Paper 9A).

9. Recognising the incremental rights and obligations arising from timing differences helps to explain fluctuations in revenue and related expenses by reporting regulatory income or regulatory expense in the same period as the revenue or expense to which it relates. This information will help users of financial statements to distinguish between:

   (a) fluctuations in revenue and related expenses compensated for through the rate-adjustment mechanism; and

   (b) fluctuations for which there is no compensation.

10. In addition, developing presentation and disclosure requirements that would provide users of financial statements with information about how timing differences have arisen and about how and when those timing will reverse will help users to predict the amounts, timing and uncertainty of future cash flows arising from regulatory assets and regulatory liabilities.

11. Users have also told us the following information would enhance their understanding of the amounts, timing and uncertainty of future cash flows arising from regulatory assets and regulatory liabilities:

    (a) the regulatory environment—the features of the regulatory framework, including the strength of the rate regulation, and the overall economic environment. These features can have distinct effects on the risks that regulated entities face compared to entities carrying out unregulated activities. Information about the regulatory environment, and changes in that environment, can help users assess the overall stability of the entity's business and revenue profiles.

    (b) the relationship between the regulator and the entity—particularly the track record of the entity in recovering costs and earning the return allowed by the rate regulation. The supportiveness of the regulatory framework in which an entity operates is commonly used as an input for an entity's credit rating and is a key consideration for assessing the stability of future cash flows. For example, the regulator's actions in terms of disputes, disallowances, rate formula changes, and delays in approvals may have a direct effect on the level of uncertainty of the future cash flows.

12. These information needs also contributed to the development of the disclosure objective of IFRS 14 *Regulatory Deferral Accounts*.

Disclosure objective in IFRS 14

13. The disclosure objective in IFRS 14 is:

    27 An entity that elects to apply this Standard shall disclose information that enables users to assess:

(a) the nature of, and the risks associated with, the rate regulation that establishes the price(s) that the entity can charge customers for the goods or services it provides; and

(b) the effects of that rate regulation on its financial position, financial performance and cash flows.

14. At the March 2018 Capital Markets Advisory Committee (CMAC) meeting, CMAC members reiterated the usefulness of the information outlined in paragraph 11. They commented that it would be helpful to bring such information together in the financial statements because it is currently scattered across various sources, sometimes in different languages. This is especially so if the entity has several rate regulated businesses subject to different regimes. Some CMAC members suggested that the disclosure objective in IFRS 14 would be a good starting point for developing the disclosure requirements of the model.

Previous discussions held with the Board

15. At its February 2017 meeting, the Board tentatively decided that the model will supplement existing IFRS Standards; ie it will adopt a 'supplementary approach'. This means that an entity within the scope of the model will apply the requirements of other IFRS Standards, including IFRS 15 *Revenue from Contracts with Customers*, without amendment, before applying the model.[2]

16. We have shown this supplementary approach in illustrative examples used in Agenda Paper 9B for this meeting and in various agenda papers presented in previous Board meetings. In those illustrative examples, we present extracts from the statement of financial performance showing the revenue and operating expense amounts determined by using existing IFRS Standards. We then show separately the 'regulatory income' or 'regulatory expense' arising from the recognition of (changes in) regulatory assets and regulatory liabilities by inserting one or more line items between revenue and operating expenses.

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2 See Agenda Paper 9A discussed at the February 2017 Board meeting. The agenda paper can be found at: https://www.ifrs.org/-/media/feature/meetings/2017/february/iasb/rate-regulated-activities/ap9a-rate-regulated-activities.pdf

17. When developing detailed presentation and disclosure requirements, we need to consider the number, description and location of possible line items and how disclosures could supplement the presentation (see paragraphs 23-31).

Initial views on the high-level presentation and disclosure objective

18. We think that the disclosure objective in IFRS 14 (paragraph 13) has the following two shortcomings:

    (a) it is too broad because it requires disclosure of the nature of, and the risks associated with, the rate regulation without necessarily linking these requirements to the regulatory assets and regulatory liabilities accounted for in the financial statements; and

    (b) it does not explain why the disclosure objective is useful for users.

19. Consequently, our initial view is to develop a new, more focused objective for the model. An initial high-level presentation and disclosure objective for the model could be as follows:

> An entity shall present and disclose information that enables users of financial statements to assess and distinguish between:
>
> - fluctuations in revenue and expenses compensated for through the rate-adjustment mechanism; and
> - fluctuations in revenue and expenses for which there is no compensation.
>
> This information will be useful because it will allow users to assess the amounts, timing and uncertainty of future cash flows arising from regulatory assets and regulatory liabilities.

20. Some of the disclosure requirements of IFRS 14 would still be relevant to this more focused objective and we could use them as the starting point for developing disclosure requirements for the model. Indeed, comments received on the Discussion Paper *Reporting the Financial Effects of Rate Regulation* published in September 2014 showed strong support for using the disclosure requirements in IFRS 14 as a starting point for developing any disclosure requirements that may

result from this project.[3] The following IFRS 14 requirements would remain relevant for each class of regulatory asset and regulatory liability:

(a) a reconciliation of the carrying amount at the beginning and end of the reporting period, showing separately amounts originating and reversing during the period, amounts acquired or disposed of, and other material changes;

(b) the remaining periods over which the entity expects the timing differences to remain outstanding;

(c) the interest/ return rate or range of rates established by the regulatory agreement to be applied to the outstanding regulatory asset or regulatory liability balance; and

(d) the amount by which a regulatory asset has been reduced when an entity concludes that a regulatory asset is no longer fully recoverable.

21. Further presentation and disclosure requirements may need to be developed to provide users of financial statements with information relating to the regulatory environment and basis for setting the rates when that information is relevant to the amounts of regulatory assets and regulatory liabilities recognised in the financial statements, such as:

(a) a description of the main components of the rate formula, such as what types of timing differences are captured by the rate-adjustment mechanism and whether interest/ return rates are established on a real or nominal basis, or on a pre- or post-tax basis;

(b) the period(s) that the regulated rates are applicable and the frequency of rate resets; and

(c) whether and, if so, how the entity is related to any of the relevant rate regulators involved in the regulatory regimes to which the entity is subject.

[3] See Agenda Paper 9 discussed by the Board at its meeting in February 2015. The paper can be found: https://www.ifrs.org/-/media/feature/meetings/2015/february/iasb/rate-regulated-activities/ap09-rate-regulated-activities.pdf

22. Unlike the disclosure objective in IFRS 14, the disclosure objective we now present in paragraph 19 would not suggest that entities are required to disclose all aspects of the nature of the rate regulation, all risks associated with that rate regulation, and all effects of rate regulation on the entity's financial position, financial performance and cash flows. Instead, it would require that entities present and disclose information that helps users of financial statements:

    (a) to understand and distinguish fluctuations in revenue and related expenses compensated for through the rate-adjustment mechanism; and

    (b) to predict the amounts, timing and uncertainty of the future cash flows arising from regulatory assets and regulatory liabilities.

Question for the Board

Presentation and disclosure objective
1. Does the Board have any comments on the staff's initial views on the high-level presentation and disclosure objective for the model as described in paragraph 19?

Exploring presentation formats for the statement(s) of financial performance

23. The Board tentatively decided that the unit of account of the model for recognition and measurement is the individual timing differences.[4] However, for presentation and disclosure, aggregating information relating to groups of timing differences will help to provide understandable information in a clear and concise way. For example, regulatory assets and regulatory liabilities could be aggregated into groups that have similar risk characteristics and similar cash flow timing patterns.

[4] See Agenda Paper 9A discussed at the February 2018 Board meeting. The paper can be found at: https://www.ifrs.org/-/media/feature/meetings/2018/february/iasb/ap9a-rate-regulated-activities.pdf

24. In the statement(s) of financial performance, we have found the basis for aggregation/ disaggregation of information less straightforward. The aim of this section is to discuss possible approaches by exploring alternative presentation formats for the fact pattern described below.

Fact pattern

25. During 20X1, Entity A:

    (a) incurs an allowable estimation variance (additional costs incurred) of CU100. The entity has a right to include that amount in the rate in 20X3. The regulatory agreement compensates the entity during the periods in which the timing difference is outstanding by giving the entity the right to charge interest at 10%, compounded annually.

    (b) includes CU40 in amounts billed to customers for service requirements that the entity will fulfil in 20X2. The regulatory agreement does not charge the entity interest on the outstanding amount.

26. As a result of these transactions, Entity A reports the following in its financial statements:

    (a) as of 31 December 20X1:

        (i) revenue that includes CU40 relating to service requirements that Entity A has not yet fulfilled but that it has already billed.

        (ii) expenses that include CU100 that Entity A has the right to be reimbursed by including CU100 in the rate billed in a future period.

        (iii) a right to bill an incremental amount of CU100 because of events that have already occurred (no interest has accrued up to this date).

        (iv) an obligation to fulfil service requirements for which it has already received compensation through the billings amounting to CU40 during that period.

(b) as of 31 December 20X2:

(i) expenses that include CU40 relating to service requirements that the entity carried out in 20X2 for which it received compensation and recognised revenue in 20X1.

(ii) a continuing right to bill an incremental amount of CU100 plus 10% accrued interest because of events that have already occurred.

(c) as of 31 December 20X3:

(i) revenue that includes CU100 to reimburse the entity for the allowance estimation variance that arose and was recognised as an expense in 20X1.

(ii) revenue that includes compound interest of CU21.

27. In addition to the above items, Entity A is entitled in each year to revenue of CU1,000 and incurs related expenses of CU600.

28. This example assumes that the interest rates established by the regulatory agreement are reasonable to use to discount the future cash flows.

Scenario 1—regulatory income / (expense) presented net

29. In Scenario 1, Entity A discounts the future cash flows arising from the regulatory asset using the interest rate of 10% given by the regulator and the accrued interest is presented within a single regulatory income /(expense) line item, which also includes the origination and reversal of both regulatory assets and regulatory liabilities (see Figure 1).

Figure 1

In CU	**20X1**	**20X2**	**20X3**	**Total**
Revenue	1,040	1,000	1,121	3,161
Regulatory income/ (expense)	60	50	(110)	0
Operating expenses	(700)	(640)	(600)	(1,940)
Profit / (loss)	**400**	**410**	**411**	**1,221**
Regulatory asset	100	110	-	-
Regulatory liability	(40)	-	-	-

Scenario 2—regulatory income / (expense) presented net with accretion of regulatory interest presented separately

30. The only difference between Scenario 1 and Scenario 2 is the presentation of the regulatory interest income / (expense) line item. In Scenario 2, regulatory interest income / (expense) is presented in a separate line item (see Figure 2).

Figure 2				
In CU	**20X1**	**20X2**	**20X3**	**Total**
Revenue	1,040	1,000	1,121	3,161
Regulatory income/ (expense)	60	40	(121)	(21)
Regulatory interest income/ (expense)	-	10	11	21
Operating expenses	(700)	(640)	(600)	(1,940)
Profit / (loss)	**400**	**410**	**411**	**1,221**
Regulatory asset	100	110	-	-
Regulatory liability	(40)	-	-	-

Scenario 1 and 2—supplementary disclosures

31. Entity A would disclose a breakdown of the regulatory income/ (expense) total amount (see Figure 3) and a reconciliation of the carrying amounts of regulatory assets and regulatory liabilities at the start and end of each year (see Figure 4).

Figure 3				
Regulatory income/ expense (in CU)	**Year X1**	**Year X2**	**Year X3**	**Total**
Origination of regulatory assets	100	-	-	100
Regulatory interest income	-	10	11	21
Recovery of regulatory asset	-	-	(100)	(100)
Recover of regulatory interest	-	-	(21)	(21)
Origination of regulatory liability	(40)	-	-	(40)
Settlement of regulatory liability	-	40	-	40
Profit / (loss)	**60**	**50**	**(110)**	**0**

Figure 4			
Reconciliation of opening and closing regulatory asset and regulatory liability balances (in CU)	**Regulatory asset**	**Regulatory liability**	**Total/ Net**
Opening balance 1 January 20X1	**-**	**-**	**-**
Amounts arising in the period	100	(40)	60
Amounts recovered/ settled in the period	-	-	-
Closing balance 31 December 20X1	**100**	**(40)**	**60**
Opening balance 1 January 20X2	**100**	**(40)**	**60**
Amounts arising in the period	10	-	10
Amounts recovered/ settled in the period	-	40	40
Closing balance 31 December 20X2	**110**	**0**	**110**
Opening balance 1 January 20X3	**110**	**0**	**110**
Amounts arising in the period	11	-	11
Amounts recovered/ settled in the period	(121)	-	(121)
Closing balance 31 December 20X3	**0**	**0**	**0**

Question for the Board

Presentation options

2. Does the Board have any comments on the presentation formats described in paragraphs 29-31?

Gross versus net presentation issues

32. As part of our presentation considerations, we have been looking at presentation requirements in existing IFRS Standards to identify whether the model would need to deal specifically with any interactions with those other Standards. We will bring an analysis of matters to a later meeting, but want to highlight a couple of issues in this meeting.

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

33. IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* permits an entity to choose, when accounting for grants related to assets:

    (a) a **net presentation** approach; ie to deduct the grant in arriving at the carrying amount of the asset; or

    (b) a **gross presentation** approach; ie to recognise the asset at its full cost in accordance with IAS 16 *Property, Plant and Equipment* and recognise a grant liability.

34. When a regulated entity receives a government grant to (partly) fund the construction of an asset, eg plant, that will be used to supply regulated goods or services, the regulatory agreement deducts the grant from the regulatory carrying amount of the asset. This means that the entity cannot include (fully) the depreciation of the plant in the future rate(s) charged to customers when it delivers regulated services using the plant. Entities may prefer to use the net presentation approach in IAS 20 to be consistent with the regulatory accounting treatment.

35. When a regulated entity receives funding from customers in advance for the construction of an asset, eg plant, the regulatory agreement deducts the prefunded customer income from the regulatory carrying amount of the asset, in the same way as it deducts government grant income.

36. However, the supplementary approach of the model requires the entity to recognise the construction cost of the plant in accordance with IAS 16, without modification, before applying the model. The prefunding received from customers creates a timing difference that the entity accounts for with the model by recognising a regulatory liability. This is consistent with the gross presentation approach in IAS 20.

37. The staff think it is undesirable to have different approaches to presenting assets such as plant, particularly when the construction of a single asset may be funded partly by a government grant and partly by payments in advance from customers. Our initial view is that the model should remove the net presentation option in

IAS 20 for regulated entities applying the model to the acquisition or construction of assets that will be used to provide regulated services.

Transfer of assets from customers

38. In some regulated industries, such as utilities, an entity may receive from its customers items of property, plant and equipment that must be used to provide regulated services to those customers. Alternatively, an entity may receive cash from customers for the acquisition or construction of such assets.

39. However, in some cases, the transferor of the asset (or cash) may not be the party that will eventually be the recipient of the regulated goods or services. For example, the transferor may be a property developer that builds a new residential area. As part of the planning permission to build the residential properties, the developer must build the pipes and other infrastructure assets necessary to connect the new homes to the regulated utility networks and 'gift' the infrastructure assets to the entities providing each utility service.

40. When a regulated entity receives such a transferred asset or cash contribution from customers or another party, the regulatory agreement deducts the contribution from the regulatory carrying amount of the asset, in the same way as it deducts government grant income (paragraph 34) and prefunded customer income (paragraph 35).

41. In January 2009, the Board issued IFRIC 18 *Transfer of Assets from Customers* to reduce divergence that had arisen in practice. That divergence arose with some entities recognising the transferred item at a cost of nil (similar to **the net presentation** approach of IAS 20) and some recognising it at fair value (a **gross presentation** approach). Among those that recognised the item at fair value, some recognised the resulting credit immediately, while others recognised it over some longer service period.

42. IFRIC 18 confirmed that a transfer within its scope was an exchange transaction within the scope of IAS 18 *Revenue* and required entities to apply a **gross presentation approach**. This meant that if an entity concluded that it controlled the transferred asset, the entity would recognise the transferred asset initially at fair value using the requirements in paragraphs 7 and 24 of IAS 16. The entity

would then apply judgement to recognise the corresponding credit amount either at a point in time or over time in accordance with IAS 18, depending on facts and circumstances.

43. As a consequence of issuing IFRS 15 *Revenue from Contracts with Customers*, the Board withdrew IFRIC 18. In doing so, the Board did not intend any change to the accounting for the transferred asset but intended any corresponding credit previously within the scope of IAS 18 to now be within the scope of IFRS 15. The staff are, however, aware that questions relating to this have arisen in practice.

44. The staff will conduct more research and outreach to consider this issue further before bringing a more detailed analysis to the Board. However, our initial view is that, to enhance consistency and comparability, the model should require entities to use a **gross presentation** approach.

Question for the Board

Gross versus net presentation
3. Does the Board have any comments on the staff's initial views in paragraphs 37 and 44?